In the Supreme Court of the United States

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OCTOBER TERM, 1971.

No. 70-79.

RELIANCE ELECTRIC COMPANY,
Petitioner,

v.

EMERSON ELECTRIC COMPANY,
Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT.

PETITION FOR REHEARING.

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Reliance Electric Company, the petitioner herein, prays that the Court grant rehearing in this cause, decided by the Court on January 11, 1972.

REASONS FOR GRANTING REHEARING.

I.

The decisive consideration in the opinion of the Court in this case is as follows (Slip Opinion, p. 6):

> "But a 'plan' to sell that is conceived within six months of purchase clearly would not fall within § 16(b) if the sale were made after the six months had expired, and we see no basis in the statute for a different result where the 10% requirement is involved rather than the six months limitation."

There is a fundamental "basis in the statute" for a quite different result in these two cases. The distinction in Section 16(b) between purchases and sales which are separated by more than six months, and purchases and sales which are not, does not reflect an arbitrary congressional preference for semiannual periods. It reflects the well-founded congressional judgment that the opportunity for speculative manipulation by insiders diminishes sharply with the passage of time:

> "Congress recognized that the longer stock is held, the greater the likelihood that the market will react to factors unforeseen by the insider. Hence the certainty of profit varies inversely with the length of the period elapsing between initial purchase and subsequent sale of a security. And in fact congressional hearings revealed that abuses of inside information took place almost entirely in short-term speculation, especially in pool operation.[10] Consequently, Congress concluded that a thorough-going penalization limited to this short-term trading would prevent most of the abuse while at the same time allowing legitimate long-term investment by insiders." Note, "The Scope of 'Purchase and Sale' Under Section 16(b) of the Exchange Act," 59 *Yale L.J.* 510, 511 (1950).

[10] Sen. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934).

The six-month limitation in Section 16(b) is based on the realities of securities markets. The insider who buys with a plan to sell *after* six months have passed has decided, by that very plan, to submit himself to the long-term investment risks to which every shareholder is subject. The legislative purpose of Section 16(b) is served, for Congress embodied in Section 16(b) its well-founded judgment that the insider who takes a long-term investment risk is probably not engaging in unfair use of insider information.

In contrast, the insider who sells via the two-step sales technique has *not* subjected himself to the investment risks of a six-month holding period. His plan is that he will *not* assume the risks to which the public shareholder is subject. He has acted as the speculator acts, taking the quick and "sure thing" profit, and the statute presumes he has used inside information unfairly in doing so. The legislative purpose, which is to prevent profit-taking on short-swing trading and thus to compel the insider to assume the same investment risks as the public shareholder, has not been served, and his profits should be taken from him. The form in which the insider carries out his disposition within six months is irrelevant to the congressional purpose.

The distinction, in short, is that he who decides to sell after six months have elapsed, and holds his stock for that period, must assume the risk of market fluctuations for a period which will in all likelihood dissipate the advantage of his insider position; he who plans to sell on the short swing and in two steps must assume only the task of finding two purchasers, which will not affect his insider advantage at all. The failure of the Court to make this distinction is a crucial misreading of the legislative purpose of Section 16(b), and should not be allowed to stand uncorrected.

II.

The opinion of the Court rests upon the conclusion, never expressly stated but necessary to the result, that the commercial and contract law of sales governs the definition of the word "sale" in Section 16(b). Thus the Court's opinion characterizes the holding of the District Court below as "a construction of the term 'at the time of sale' that treats two sales as one." Slip Opinion, p. 7. Nowhere,

however, does the Court address itself to the question whether in fact Emerson made two "sales" or one "sale" *as that term is used in Section 16(b)*. Nor does the Court address itself to the question whether Emerson's transactions were in substance one transaction, although in contractual form two, despite the fact that District Judge Regan based his holding upon this substance over form analysis.

The Court's position here cannot be reconciled with its decision in *SEC v. National Securities, Inc.*, 393 U.S. 453, 465-68 (1969). There the Court was presented with the question whether a particular transaction, clearly not a sale in contract or commercial law, constituted a "purchase or sale" under the definitions of those terms in Sections 3(a)(13) and 3(a)(14) of the Securities Exchange Act of 1934 and in the context of Section 10(b). After commenting on the breadth of the definitions themselves, the Court, through Mr. Justice Marshall, stated that the test of "purchase or sale" as those terms are used in the 1934 Act was "whether respondents' alleged conduct is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule." 393 U.S. at 467. In the present case, the Court was presented with the question whether Emerson's transactions constituted a single "sale" under the definition of that term in the same Section 3(a)(14) of the Securities Exchange Act, in the context of Section 16(b). Departing from the rule of *National Securities*, the Court did *not* examine whether Emerson's conduct was the type of behavior meant to be forbidden by the statute; indeed, the Court *expressly declined to make this crucial determination*, stating that: *"If* a 'two-step' sale of a 10% owner's holdings within six months of purchase is thought to give rise to the kind of evil that Congress sought to correct through § 16(b),

those transactions can be more effectively deterred by an amendment to the statute . . . ." (Slip Opinion, p. 7; emphasis added.) If the Court intended here to overrule *National Securities,* that should be stated; if not, the distinction in principle, if any, should be explained. As it stands, *National Securities* is under a cloud of the Court's making.

For at least fourteen years, federal Courts of Appeal have applied under Section 16(b) the test of "purchase or sale" set forth in *National Securities:* ". . . whether a given transaction could possibly tend to accomplish the practices Section 16(b) was designed to prevent." *Blau v. Lamb,* 363 F.2d 507, 519 (2d Cir. 1966), *cert. denied,* 385 U.S. 1002 (1967). In opting for a "mechanical quality" in the statute, the Court has rejected the line of cases from *Ferraiolo v. Newman,* 259 F.2d 342 (6th Cir. 1958), *cert. denied,* 359 U.S. 927 (1959), through *Abrams v. Occidental Petroleum Corp.,* 450 F.2d 157 (2d Cir. 1971),[1] and has returned to the mechanistic and frequently-criticized view of *Park & Tilford, Inc. v. Schulte,* 160 F.2d 984 (2d Cir.), *cert. denied,* 332 U.S. 761 (1947).

The Court has wrongly failed to determine whether Emerson's transactions, *objectively defined,* present the possibility of speculative abuse and thus should be held to constitute a single "sale" in the context of Section

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[1] In *Abrams v. Occidental Petroleum Corp., supra,* cited in petitioner's Reply Brief, the Second Circuit Court of Appeals held that an exchange of shares in one corporation for those of another pursuant to a merger agreement does *not* constitute a "sale" within the meaning of Section 16(b) where there was no possibility of speculative abuse, distinguishing *Newmark v. RKO General, Inc.,* 425 F.2d 348 (2d Cir.), *cert. denied,* 400 U.S. 854 (1970), where there was opportunity for speculative abuse. Footnote 2 of the Court's opinion is erroneous in that it fails to reflect what has been the position of the Second Circuit since a month prior to argument in this case.

16(b), whatever the commercial or contract law characterization of the transactions might be.[2]

When a 10% beneficial owner sells all his shares pursuant to a single contract within six months of their purchase, the possibility of unfair use of inside information is present. The possibility of abuse is not diminished one bit when the 10% beneficial owner sells his stock pursuant to two contracts rather than one. When the Court holds that the form in which the insider chooses to effectuate his disposition of stock determines the applicability of Section 16(b), the Court has subordinated the expressed intent of Congress, to prevent "the unfair use of information which may have been obtained . . ." to a judicially-created ideal of easy administration and mechanical applicability.[3]

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[2] The Court rightly rejected the presence or absence of intent-to-avoid-Section 16(b)-liability as a test for imposition of liability. But the intent-which-determines-the-character-of-the transaction-itself is a different thing entirely. *Truncale v. Blumberg*, 80 F. Supp. 387, 391-92 (S.D.N.Y. 1948). Emerson intended, and in substance made, one disposition of stock, as the District Court found. Emerson's counsel's letter is only one evidence of the fact that a single disposition was intended. Further evidences that Emerson intended a single disposition were the facts that Emerson's first sale left Emerson with precisely 9.96% of Dodge's outstanding stock, and that Emerson's negotiations for its second sale commenced before its first sale was closed. The transactions, objectively defined, were one sale.

[3] The Court's opinion reflects a reluctance to impose Section 16(b) liability on the two-step sales technique because of uncertainty as to the rule which should govern future cases. Petitioner submits that uncertainty whether two sales within six months of a purchase should be irrebuttably presumed to be connected, as the SEC suggests, or rebuttably presumed connected, as the dissenting opinion suggests, is not a reason for refusing to impose liability in a case in which the trial court has found on the evidence that the two sales were connected as parts of a single disposition. In the event rehearing is granted, petitioner will brief in full the question of what rule will preserve the legislative purpose and at the same time provide guidance to the courts for relatively easy administration.

III.

In this case the Court has approved a technique whereby any 10% beneficial owner can now insulate from Section 16(b) a substantial portion of profits realized by him on short-swing purchases and sales. The two-step sales technique was not widely used in the past; this case is the first in which its lawfulness has been raised, and in none of the otherwise similar cases arising out of the 1967-68 tender offer period was the technique used.[4] Perhaps misled by a mistaken belief that the technique has been widely used, the Court did not appear to recognize in its opinion the fact that it was for the first time in the history of Section 16(b) giving judicial approval to a technique for profiting from inside information by short-term trading.

The financial community quickly recognized the novelty and the consequences of the Court's decision; the financial press recognized the Court's decision as a change in the direction of the law. The Wall Street Journal of January 12, 1972, headlined its article on the decision: "Supreme Court Opens Up Loophole in Trading by Corporation Insiders." Its lead paragraphs were as follows:

> "WASHINGTON—The Supreme Court opened a large loophole in the law Congress passed 38 years ago to prevent corporate insiders from speculating in their companies' securities.
>
> "The court's four-to-three decision, reflecting a new conservatism on business issues, will enable a large stockholder who engages in 'short-swing' transactions to avoid a major part of the liability that would have been incurred under the previous understanding of the law."

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[4] See, *e.g.*, *Abrams v. Occidental Petroleum Corp.*, *supra*; *American Standard, Inc. v. Crane Co.*, ___ F. Supp. ____, CCH Fed. Sec. L. Rep. ¶ 93,237 (S.D.N.Y. 1971).

The New York Times of January 12, 1972, was equally alert to the implications of the Court's decision for the financial community:

> "WASHINGTON, Jan. 11—The Supreme Court ruled today that certain corporate 'insiders' can avoid some of the financial penalties for 'insider trading' if they sell the company's stock in two separate transactions instead of all at once."

Although it accurately reported the impact of the Court's decision, the financial press was in error in regarding it as a pro-business or conservative decision. It is not. It is a pro-speculator decision, a pro-raider decision, but not a pro-business decision. It is in the interest of every publicly-held business in this country to have the investing public assured that insiders cannot take advantage. The decision of the Court, which shows speculators how to plan their transactions and draft their contracts so as to take and keep short-swing profits, will be followed by clever insiders, and the confidence of the investing public will be eroded. The congressional purpose behind much of the Securities Exchange Act of 1934, which is to maintain investor confidence that securities markets are honest, will be impeded by this decision.

IV.

Petitioner submits that, in the opinion of the Court in this cause, the Court (1) did not make the important distinction between an insider who determines to sell after holding his purchased stock for six months, and the insider who determines to take an immediate short-term profit by adopting a particular technique for sale within six months; (2) did not decide whether Emerson's transactions afforded the possibility of abuse of inside information, and thus should be treated as one "sale" as the term is used in Section 16(b), departing from its own ruling in

National Securities, supra, in doing so; and (3) did not advert to the opportunities for unfair use of inside information which its decision would make available to all well-advised speculators. Since this is only the second case arising under Section 16(b) which this Court has heard in the history of the 1934 Act, the Court should not allow its January 11, 1972 opinion, which fails to deal with these crucial questions, to stand as the decision in this case.

This Petition for Rehearing should be granted, and the case set down for reargument.

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CERTIFICATE OF COUNSEL

I certify that this petition is presented in good faith and not for delay.

PATRICK J. AMER

RELIANCE ELECTRIC CO. *v.* EMERSON ELECTRIC CO.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 70–79. Argued November 10–11, 1971—
Decided January 11, 1972

Respondent, the owner of more than 10% of Dodge Mfg. Co.'s stock, within six months of the purchase thereof sold enough shares to a broker to reduce its holding to 9.96%, for the purpose of immunizing the disposal of the remainder from liability under § 16 (b) of the Securities Exchange Act of 1934. Under that provision a corporation may recover for itself the profits realized by an owner of more than 10% of its shares from a purchase and sale of its stock within any six-month period, provided the owner held more than 10% "both at the time of purchase and sale." *Held:* Under the terms of § 16 (b) respondent is not liable to petitioner (Dodge's successor) for profits derived from the sale of the 9.96% to Dodge within six months of purchase. Pp. 419–427.

434 F. 2d 918, affirmed.

STEWART, J., delivered the opinion of the Court, in which BURGER, C. J., and MARSHALL and BLACKMUN, JJ., joined. DOUGLAS, J., filed a dissenting opinion, in which BRENNAN and WHITE, JJ., joined, *post*, p. 427. POWELL and REHNQUIST, JJ., took no part in the consideration or decision of the case.

Thomas P. Mulligan argued the cause for petitioner. With him on the briefs were *Patrick J. Amer, Stephen J. Burns,* and *Kenneth S. Teasdale.*

Albert E. Jenner, Jr., argued the cause for respondent. With him on the brief were *Wesley G. Hall, R. H. McRoberts,* and *Thomas C. Walsh.*

Walter P. North argued the cause for the Securities and Exchange Commission as *amicus curiae.* With him on the briefs were *Solicitor General Griswold, Samuel Huntington, Philip A. Loomis, Jr.,* and *Jacob H. Stillman.*

Whitney North Seymour and *John A. Guzzetta* filed a brief for Gulf & Western Industries, Inc., as *amicus curiae.*

MR. JUSTICE STEWART delivered the opinion of the Court.

Section 16 (b) of the Securities Exchange Act of 1934, 48 Stat. 896, 15 U. S. C. § 78p (b), provides, among other things, that a corporation may recover for itself the profits realized by an owner of more than 10% of its shares from a purchase and sale of its stock within any six-month period, provided that the owner held more than 10% "both at the time of the purchase and sale." [1] In this case, the respondent, the owner of 13.2% of a corporation's shares, disposed of its entire holdings in two sales, both of them within six months of purchase. The

[1] Section 16 (b) provides:

"For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . . This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." 15 U. S. C. § 78p (b).

The term "such beneficial owner" refers to one who owns "more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title." Securities Exchange Act of 1934, § 16 (a), 15 U. S. C. § 78p (a).

first sale reduced the respondent's holdings to 9.96%, and the second disposed of the remainder. The question presented is whether the profits derived from the second sale are recoverable by the Corporation under § 16 (b). We hold that they are not.

I

On June 16, 1967, the respondent, Emerson Electric Co., acquired 13.2% of the outstanding common stock of Dodge Manufacturing Co., pursuant to a tender offer made in an unsuccessful attempt to take over Dodge. The purchase price for this stock was $63 per share. Shortly thereafter, the shareholders of Dodge approved a merger with the petitioner, Reliance Electric Co. Faced with the certain failure of any further attempt to take over Dodge, and with the prospect of being forced to exchange its Dodge shares for stock in the merged corporation in the near future,[2] Emerson, following a plan outlined by its general counsel, decided to dispose of enough shares to bring its holdings below 10%, in order to immunize the disposal of the remainder of its shares from liability under § 16 (b). Pursuant to counsel's recommendation, Emerson on August 28 sold 37,000 shares of Dodge common stock to a brokerage house at $68 per share. This sale reduced Emerson's holdings in Dodge to 9.96% of the outstanding common stock. The remaining shares were then sold to Dodge at $69 per share on September 11.

After a demand on it by Reliance for the profits realized on both sales, Emerson filed this action seeking a declaratory judgment as to its liability under § 16 (b). Emerson first claimed that it was not liable at all,

[2] The Court of Appeals for the Second Circuit has held that an exchange of shares in one corporation for those of another pursuant to a merger agreement constitutes a "sale" within the meaning of § 16 (b). *Newmark* v. *RKO General, Inc.*, 425 F. 2d 348, 354.

because it was not a 10% owner at the time of the *purchase* of the Dodge shares. The District Court disagreed, holding that a purchase of stock falls within § 16 (b) where the purchaser becomes a 10% owner by virtue of the purchase. The Court of Appeals affirmed this holding, and Emerson did not cross-petition for certiorari. Thus that question is not before us.

Emerson alternatively argued to the District Court that, assuming it was a 10% stockholder at the time of the purchase, it was liable only for the profits on the August 28 sale of 37,000 shares, because after that time it was no longer a 10% owner within the meaning of § 16 (b). After trial on the issue of liability alone, the District Court held Emerson liable for the entire amount of its profits. The court found that Emerson's sales of Dodge stock were "effected pursuant to a single predetermined plan of disposition with the overall intent and purpose of avoiding Section 16 (b) liability," and construed the term "time of . . . sale" to include "the entire period during which a series of related transactions take place pursuant to a plan by which a 10% beneficial owner disposes of his stock holdings" 306 F. Supp. 588, 592.

On an interlocutory appeal under 28 U. S. C. § 1292 (b), the Court of Appeals upheld the finding that Emerson "split" its sale of Dodge stock simply in order to avoid most of its potential liability under § 16 (b), but it held this fact irrelevant under the statute so long as the two sales are "not legally tied to each other and [are] made at different times to different buyers . . . ." 434 F. 2d 918, 926. Accordingly, the Court of Appeals reversed the District Court's judgment as to Emerson's liability for its profits on the September 11 sale, and remanded for a determination of the amount of Emerson's liability on the August 28 sale. Reliance filed a petition for certiorari, which we granted

in order to consider an unresolved question under an important federal statute. 401 U. S. 1008.

II

The history and purpose of § 16 (b) have been exhaustively reviewed by federal courts on several occasions since its enactment in 1934. See, *e. g., Smolowe* v. *Delendo Corp.*, 136 F. 2d 231; *Adler* v. *Klawans*, 267 F. 2d 840; *Blau* v. *Max Factor & Co.*, 342 F. 2d 304. Those courts have recognized that the only method Congress deemed effective to curb the evils of insider trading was a flat rule taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great. As one court observed:

> "In order to achieve its goals, Congress chose a relatively arbitrary rule capable of easy administration. The objective standard of Section 16 (b) imposes strict liability upon substantially all transactions occurring within the statutory time period, regardless of the intent of the insider or the existence of actual speculation. This approach maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof. Such arbitrary and sweeping coverage was deemed necessary to insure the optimum prophylactic effect." *Bershad* v. *McDonough*, 428 F. 2d 693, 696.

Thus Congress did not reach every transaction in which an investor actually relies on inside information. A person avoids liability if he does not meet the statutory definition of an "insider," or if he sells more than six months after purchase. Liability cannot be imposed simply because the investor structured his transaction with the intent of avoiding liability under § 16 (b). The question is, rather, whether the method used to "avoid" liability is one permitted by the statute.

Among the "objective standards" contained in § 16 (b) is the requirement that a 10% owner be such "both at the time of the purchase and sale . . . of the security involved." Read literally, this language clearly contemplates that a statutory insider might sell enough shares to bring his holdings below 10%, and later—but still within six months—sell additional shares free from liability under the statute. Indeed, commentators on the securities laws have recommended this exact procedure for a 10% owner who, like Emerson, wishes to dispose of his holdings within six months of their purchase.[3]

Under the approach urged by Reliance, and adopted by the District Court, the apparent immunity of profits derived from Emerson's second sale is lost where the two sales, though independent in every other respect, are "interrelated parts of a single plan." 306 F. Supp., at 592. But a "plan" to sell that is conceived within six months of purchase clearly would not fall within § 16 (b) if the sale were made after the six months had expired, and we see no basis in the statute for a different result where the 10% requirement is involved rather than the six-month limitation.

The dissenting opinion, *post*, at 442, reasons that "the 10% rule is based upon a conclusive statutory presumption that ownership of this quantity of stock suffices to

[3] "[A] person who owns 15 percent and wants to sell down to 5 percent should sell 5-plus percent in one transaction and then, after he becomes a holder of slightly less than 10 percent, sell out the remainder." 2 L. Loss, Securities Regulation 1060 (2d ed. 1961).

"[T]he intention of the language was to exclude the second sale in a case where 10% is purchased, 5% sold within three months and the remaining 5% a month later. This latter construction of the Act is, it is believed, the only safe one to rely upon." Seligman, Problems Under the Securities Exchange Act, 21 Va. L Rev. 1, 20 (1934).